

# FISCAL NOTE

**Bill #:** HB765

**Title:** Generally revise tax structure

**Primary Sponsor:** Erickson, R

**Status:** As Introduced

Sponsor signature	Date	Chuck Swysgood, Budget Director	Date
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## Fiscal Summary

**FY 2004**

**FY 2005**

**Difference**

**Difference**

### Expenditures:

General Fund

\$3,921,111

\$6,591,280

### Revenue:

General Fund

\$0

\$222,505,000

### Net Impact on General Fund Balance:

\$(3,921,111)

\$215,913,720

- |                                                           |                                                                   |
|-----------------------------------------------------------|-------------------------------------------------------------------|
| <input type="checkbox"/> Significant Local Gov. Impact    | <input checked="" type="checkbox"/> Technical Concerns            |
| <input type="checkbox"/> Included in the Executive Budget | <input checked="" type="checkbox"/> Significant Long-Term Impacts |
| <input type="checkbox"/> Dedicated Revenue Form Attached  | <input checked="" type="checkbox"/> Needs to be included in HB 2  |

## Fiscal Analysis

### ASSUMPTIONS:

#### General Retail Sales Tax

1. Beginning January 1, 2005, this bill would impose a 4% sales and use tax on retail sales of tangible personal property and services with the following exemptions: sales for resale or lease; health services; utilities; educational services; agricultural, forestry, fishing and hunting services; radio and television broadcasting; scheduled passenger transportation; farm product warehousing and storage; security brokerage fees; insurance commissions; services a corporation provides to an affiliate or subsidiary that is centrally assessed; telecommunications services subject to the retail telecommunications excise tax; gambling; sales by or to a government or tribe; sales by tax-exempt thrift stores; unprepared food; prepared food that is part of a residential or health care arrangement; medicine, durable medical equipment, mobility enhancing equipment and therapeutic and prosthetic devices; motor fuels; agricultural inputs except machinery; agricultural products; minerals or chemicals used in processing ores; components used in manufacturing; and oilfield and mining equipment that must be abandoned in place.
2. In the half of FY05 when the sales tax would be in effect, taxable sales would be \$6,329.774 million and tax liability would be \$253.191 million. Vendors would collect tax equal to 95% of liability, or \$240.531 million.
3. There would be 55,000 businesses collecting the tax on their sales. Vendors with average tax liability of less than \$100 a month would be allowed to file returns quarterly, and all others would file monthly. Monthly filers would be allowed to retain 2.5% of collections with a maximum of \$100 a month as a

## Fiscal Note Request HB765, As Introduced

(continued)

vendor allowance. Quarterly filers would be allowed to retain 4% of collections (see technical note 1). Vendor allowances in fiscal 2005 would be \$7.059 million.

4. All sales tax revenue would be deposited in the general fund. Revenue in FY05 would be \$233.472.

### Property Tax

5. The proposal decreases the tax rate on class 4 and class 3 property from 3.46% to 3.00% beginning with tax year 2005.
6. The proposal increases the homestead exemption for class 4 residential property from 31% to 66.5% beginning in with tax year 2005. The net result will be decrease in property taxes paid of 50.3%.
7. The proposal increases the comstead exemption for class 4 commercial property from 13% to 29.5% beginning in with tax year 2005. The net result will be decrease in property taxes paid of 17.9%.
8. The proposal introduces an exemption for class 3 agricultural land of 18.0% beginning in with tax year 2005. The net result will be decrease in property taxes paid of 18.0%.
9. The changes in the tax rate and exemption levels will result in a decrease in taxable value beginning with FY06. It is estimated the taxable value of the state will be reduced by \$490,118,215. Such a reduction will result in a decrease in general fund revenue of \$46,561,230 ( $\$490,118,215 \times .095$ ) and a decrease in revenue for the university system revenue of \$2,940,709 ( $\$490,118,215 \times .006$ ) beginning in FY06.

### Individual Income Tax

10. Beginning with tax year 2005 this bill would restructure Montana's individual income tax by tying state tax liability to federal taxable income. Under the provisions of this bill taxpayers' calculation of individual income taxes would start with federal taxable income. Taxpayers would be required to add back the following items of income, and would be allowed to deduct the following items of income in calculating Montana taxable income under this bill:

<b>HB765 Tax Base</b>
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**Starting Point: Federal Taxable Income**

**Plus:**

Non-Montana Local Government Interest  
Certain Distributions from a Montana Farm and Ranch Risk Management Account  
Nonqualified Withdrawals from Medical Savings, Family Education, and  
First-Time Homebuyer Savings Accounts

**Less:**

US Savings Bond Interest  
Unemployment Insurance  
Medical Insurance Premiums  
Long-Term Care Insurance Premiums  
Contributions to Medical Savings Accounts  
Contributions to Family Education Savings Accounts  
Contributions to First-Time Homebuyers Savings Accnts.  
Up to \$4,700 of Retirement Income; Phased Out for Incomes Over \$60,000

**Equals: Montana Taxable Income**

**Fiscal Note Request HB765, As Introduced**  
(continued)

Under this bill taxpayers would determine their tax liabilities using alternative tax rate tables depending on the taxpayer's filing status as follows:

HB765 Tax Rate Tables - TY2005				HB765 Tax Rate Tables - TY2006			
SINGLE FILERS				SINGLE FILERS			
\$0	\$2,910	4.00%		\$0	\$3,000	4.00%	
\$2,910	\$12,630	5.00%	(\$29)	\$3,000	\$13,000	5.00%	(\$30)
\$12,630	\$23,310	6.00%	(\$155)	\$13,000	\$24,000	6.00%	(\$160)
\$23,310		6.60%	(\$295)	\$24,000		6.60%	(\$304)
HEAD OF HOUSEHOLD				HEAD OF HOUSEHOLD			
\$0	\$4,656	4.00%		\$0	\$4,800	4.00%	
\$4,656	\$20,208	5.00%	(\$47)	\$4,800	\$20,800	5.00%	(\$48)
\$20,208	\$37,296	6.00%	(\$249)	\$20,800	\$38,400	6.00%	(\$256)
\$37,296		6.60%	(\$472)	\$38,400		6.60%	(\$486)
MARRIED COUPLES				MARRIED COUPLES			
\$0	\$5,820	4.00%		\$0	\$6,000	4.00%	
\$5,820	\$25,260	5.00%	(\$58)	\$6,000	\$26,000	5.00%	(\$60)
\$25,260	\$46,620	6.00%	(\$311)	\$26,000	\$48,000	6.00%	(\$320)
\$46,620		6.60%	(\$591)	\$48,000		6.60%	(\$608)

11. Under this bill all married taxpayers are required to file using the same filing status as that used for federal income tax purposes. Nearly all married couples will file using the filing status married filing jointly.
12. As with current law, taxpayers will be required to include any federal income tax refunds received in tax year 2005 in taxable income under the transition provisions of this bill. This would not be required for tax year 2006 returns, and subsequent years.
13. The Department of Revenue will adjust withholding tables beginning January 1, 2005 to take the net overall income tax reduction in this bill into account; taxpayers will also adjust their quarterly estimated tax payments to take any tax reductions or increases inherent in this bill into account.
14. Under this bill, tax liabilities of *full-year resident filers* will decrease by \$18.143 in tax year 2004; and by \$42.845 million in tax year 2006. Total tax liabilities of *all filers (including part-year and nonresident filers)* will decrease by \$20.584 million in tax year 2005; and by \$49.289 million in tax year 2006.
15. Under this bill, net collections to the state general fund from the changes to the income tax structure are reduced by \$10.967 million in fiscal 2005 by \$36.344 million in fiscal 2006.

**Refundable Sales Tax Credit**

16. This bill provides for a *refundable* sales tax credit for every resident and part-year resident taxpayer. To the extent that the credit amount exceeds the taxpayer's tax liability the Department of Revenue will refund the balance to the taxpayer. The credit is equal to \$200 for each individual filing separately, and \$400 for each head of household and married couple filing a joint return. The claim for this credit must be submitted at the same time that the claimant's individual income tax return is due. For a claimant not

**Fiscal Note Request HB765, As Introduced**  
(continued)

required to file a tax return, a claim must be submitted on or before April 15 of the year following the year for which the credit is claimed.

17. Because this credit applies beginning with tax year 2005, taxpayers will not claim the credit first until the spring of 2006. Thus, there is no impact from this credit in fiscal year 2005.
18. Based on the number of taxpayers filing income tax returns in tax year 2001, this credit is anticipated to reduce general fund revenues by \$117.700 million in fiscal year 2006, and each fiscal year thereafter.

**Nonrefundable Student Loan Tax Credit**

19. Beginning in tax year 2005, this bill would allow persons who receive a degree from a Montana institution of higher education and have more than a certain amount of student loan debt at the time of graduation to claim a non-refundable credit against personal income tax in the first year following the year of graduation, and up to nine succeeding years until the student loans are repaid. A person receiving an associate or bachelor's degree and having at least \$5,000 in student loans would be able to claim a credit equal to the amount of student loan repaid, up to \$500 per year. A person receiving a masters or doctoral degree and having at least \$10,000 in student loans would be able to claim a credit equal to the amount of student loan repaid, up to \$1,000 per year. The credit for each year cannot be carried forward or backward.
20. The credit would first be claimed by school year 2006 graduates on their returns for tax year 2007, filed in 2008. Credits totaling \$1.1 million would be claimed, reducing general fund revenue by \$1.1 million in fiscal 2008. (Office of the Commissioner of Higher Education)
21. Taxpayers who claimed the credit on their 2007 tax returns would claim the same amount on their 2008 returns, and school year 2007 graduates would claim \$1.1 million in credits on their 2008 tax returns. This would reduce general fund revenue by \$2.2 million in fiscal 2009.

**Refundable Elderly Tax Credit for Insulin and Prescription Drug Purchases**

22. Under this bill, qualifying taxpayers age 65 and older may receive a *refundable* credit for the actual out-of-pocket expenses incurred for insulin or prescription drugs or medicine equal to 50% of the amount paid, up to a maximum credit of \$350. The credit applies beginning with tax year 2005. There is no impact from this credit in fiscal year 2005, and the full impact of the first year's credit will occur in fiscal year 2006.
23. For single and head of household taxpayers the full credit is allowed only for households with incomes up to \$22,500; and is then reduced by \$1 for every \$5 of income over \$22,500 so that no credit is allowed for households with incomes in excess of \$24,250. For married couples the full credit is allowed only for households with incomes up to \$36,000; and is then reduced by \$1 for every \$5 of income over \$36,000 so that no credit is allowed for married couple households with incomes in excess of \$37,750.
24. Based on an examination of Census 2000 and individual income tax database information, there are 54,000 persons age 65 or older with incomes that qualify them for the credit. Utilization rates for this credit will be high with one-third of all eligible persons using the credit in the first year of the program, half of all eligible persons using the credit in the second year of the program, and two-thirds of all eligible persons using the credit in the third and subsequent years of the program. All persons using the credit will take the maximum credit of \$350.
25. The above assumptions result in tax credits of \$6,300,000 for tax year 2005 (fiscal year 2006); \$9,450,000 for tax year 2006 (fiscal year 2007); and \$12,600,000 for tax year 2007 (fiscal year 2008).

**Increase in Elderly Homeowner/Renter Credit**

26. Under current law, elderly homeowners and renters are allowed a refundable credit against individual income taxes for a portion of the property taxes paid during the tax year. For renters, the property tax equivalent is 15% of rent paid. This bill increases the rental equivalency for renters to 30% of rent paid. Based on a simulation analysis of all taxpayers taking the elderly homeowner/renter credit in tax year

**Fiscal Note Request HB765, As Introduced**  
(continued)

2001, it is estimated that increasing the rental equivalency for renters to 30% of rent paid would increase the elderly homeowner/renter credit claimed each year by \$2.662 million.

27. The increase in this credit for renters applies first to tax year 2005. Increased credits will not be claimed until the spring of 2006 (fiscal year 2006) when taxpayers file their income tax returns for tax year 2005. This provision of the bill will reduce general fund revenues by \$2.662 million in fiscal year 2006, and in each fiscal year thereafter.

**Tax Administration**

28. The Department of Revenue would need to implement a new data processing system to administer the sales and use tax and income tax rebates. The department would buy software from an outside vendor, and the department and the vendor would customize it. The department also would need to make modifications to the existing income tax system and property tax system. Cost for the system would be \$3,387,294 in fiscal 2004 and \$3,518,371 in fiscal 2005. Computers and office equipment for contract programmers would cost \$26,567 in fiscal 2004. Beginning in fiscal 2006, ongoing costs for software maintenance and storage on the state's network would be \$220,000.
29. The Department of Revenue would need to register 55,000 taxpayers, develop and mail tax forms and instructions, conduct taxpayer education and outreach, and hire and train new staff to administer the sales tax. Beginning in calendar year 2005, the department would process approximately 620,000 returns and audit 1,100 taxpayers each year. The department would begin hiring new staff for processing, compliance, and support work before the tax went into effect. By the end of fiscal 2004, 7 FTE would be hired, and an additional 59.88 FTE would be hired in fiscal 2005. Personnel costs would be \$188,179 in fiscal 2004 and \$2,117,202 in fiscal 2005. Costs for computers and office equipment for the additional staff would be \$119,170 in fiscal 2004 and \$385,971 in fiscal 2005. Operating costs, including forms development, travel by auditors, and consulting services from an experienced sales tax administrator from another state would be \$199,901 in fiscal 2004 and \$569,736 in fiscal 2005. Ongoing costs would be the same as in fiscal 2005 except for the equipment costs.

FISCAL IMPACT:

	FY 2004 <u>Difference</u>	FY 2005 <u>Difference</u>
FTE	7.00	66.88

Expenditures:

Personal Services	\$188,179	\$2,117,202
Operating Expenses	\$3,587,195	\$4,088,107
Equipment	<u>\$145,737</u>	<u>\$385,971</u>
TOTAL	\$3,921,111	\$6,591,280

Funding of Expenditures:

General Fund (01)	\$3,921,111	\$6,591,280
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Revenues:

General Fund (01)	\$0	\$222,505,000
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Net Impact to Fund Balance (Revenue minus Funding of Expenditures):

General Fund (01)	\$(3,921,111)	\$215,913,720,
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EFFECT ON COUNTY OR OTHER LOCAL REVENUES OR EXPENDITURES:

## Fiscal Note Request HB765, As Introduced

(continued)

The changes in the tax rate and exemption levels will result in a decrease in property tax revenue of \$198,751,159 beginning in FY2006 for local governments and local schools. The proposal includes a reimbursement mechanism to offset this loss in property tax revenue.

### LONG-RANGE IMPACTS:

Fiscal 2006 is the first year when the sales tax would be in effect for the whole year. Net revenue to the general fund from the sales tax would be \$481.768 million. Sales tax collections would grow about 3.1% per year.

### TECHNICAL NOTES:

1. Section 42 allows quarterly sales tax filers to retain 4% of collections with a maximum of \$200 a quarter. A vendor would hit the \$200 cap with sales of \$125,000 in a quarter. However, Section 40 requires vendors with average monthly collections of \$100 or more to file monthly. This is equivalent to annual sales of \$30,000. Thus, no quarterly filers will be at their vendor allowance cap.
2. Section 11 exempts certain types of services from the sales and use tax. It defines those services with reference to the North American Industry Classification System (NAICS). The NAICS manual contains definitions of *industries*, not of *goods and services*. For example, subsection (a) exempts health services and cites NAICS sector 62. NAICS sector 62 consists of *establishments* whose primary function is providing health care and social assistance. Thus, Section 11 defines health services as hospitals and doctors' and dentists' offices. This fiscal note assumes that the exemptions in section 11 are for sales in the primary lines of business that define the NAICS industries referenced, not for all sales by establishments in those industries. The NAICS industry classification system was developed by the Census Bureau and its counterparts in Canada and Mexico. The agencies are in the process of developing the North American Product Classification System (NAPCS), which will be a classification system for goods and services. Preliminary NACPS definitions are available for some types of goods and services. Section 11 should reference NACPS definitions where they are available. Otherwise, the bill should provide definitions or leave definitions to the rulemaking process.